CEPAL

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SANTIAGO, CHILE, APRIL 1989

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Notes and explanation of symbols

The following symbols are used in tables in the *Review:*
Three dots (...) indicate that data are not available or are not separately reported.
A dash (—) indicates that the amount is nil or negligible.
A blank space in a table means that the item in question is not applicable.
A minus sign (-) indicates a deficit or decrease, unless otherwise specified.
A point (.) is used to indicate decimals.
A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.
Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.
Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.
Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.
Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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CEPAL REVIEW No. 37

Latin America's prospects in the financial markets

*Alfred J. Watkins**

Since the onset of the debt crisis, officials in both creditor and debtor nations have declared that commercial banks would resume making new loans to developing country borrowers once the debtors completed their macroeconomic adjustments and restored their creditworthiness. However, the commercial banks' long-term business interests may no longer coincide with Latin America's debt service and investment requirements.

During the 1970s, virtually every financial market development damaged the commercial banks' domestic business opportunities and enhanced Latin America's access to external financial resources. In both the United States and Japan, the banks shifted their lending operations to developing countries, whose appetite for external financial resources rescued the banks from the threat of stagnation.

The 1980s have been entirely different. Virtually every evolutionary trend and regulatory development in the financial markets during this decade has reduced the Latin American countries' access to external financial resources. Moreover, many of the changes that are expected to unfold during the remainder of this decade and the early part of the 1990s will increase the cost of making syndicated loans to Latin America at the same time that they offer banks a broad array of new profit-making opportunities within developed country markets. Consequently, it is unlikely that commercial bank growth strategies and Latin America's external capital requirement will once again coincide anytime soon.

*ECLAC Consultant. The author thanks Isaac Cohen, Walter Cabrera, Martine Guerguil and Robert Devlin for their helpful comments and suggestions.

Introduction

The financial market innovations of the 1980s opened new vistas for most international borrowers and lenders. New techniques of financial market intermediation reduced costs for borrowers and increased returns for lenders. For the first time, national currencies and national boundaries were not significant barriers to cross-border capital flows. With the globalization, integration, and deregulation of various financial markets, borrowers could compare borrowing costs in different locations and raise funds in the financial centre and currency that offered the lowest price at any particular moment. If that particular currency and interest rate structure was not optimal, currency and interest rate swaps —along with other financial engineering techniques— could improve the match between assets and liabilities. Meanwhile, increased competition among lenders, both in different financial centres and within each centre, ensured that borrowers would enjoy maximum access to the full range of innovations and that borrowing costs would be pared to the bone.

The benefits of this financial revolution have largely bypassed Latin America. Except for an occasional concerted lending package —generally arranged under the threat of a debt service moratorium or some other financial crisis— the financial markets stopped supplying Latin America with external capital. Several factors account for this reluctance, not the least of which is the region's large external debt and the associated decline in creditworthiness. But several important trends associated with the globalization, integration and liberalization of the international financial markets have also been important.

For most of this decade, a rising fraction of the world's financial resources flowed through the securities markets. The syndicated loan market, where Latin American sovereign borrowers raised the vast majority of their external funds during the 1970s, had fallen out of favour with international borrowers and lenders, at least until recently. Simultaneously, new financial market regulations in many of the traditional creditor countries gave banks an opportunity to offer their developed country customers a much broader array of financial services

and to offer their traditional commercial banking services to a wider range of developed country customers. This made it relatively more costly for banks to stay in the syndicated loan business. Not surprisingly, syndicated loans to developing countries —including those that did not experience severe debt servicing difficulties— were no longer viewed as an important profit centre for many commercial banks.

Compounding these problems is the fact that for a variety of reasons having little or nothing to do with Latin America's financial problems, United States banks have been retreating from the international lending arena. They have stopped increasing their exposure, not just to developing countries with external debt problems, but to countries in virtually every region of the globe, developed and developing alike. Since United States banks were in the forefront of lending to Latin America during the 1970s, their eclipse by Japanese banks and general retreat from international lending can be expected to have profound ramifications for Latin America. More specifically, if Latin America's traditional source of external capital is becoming more insular while new entrants into the international lending arena are focusing their attentions elsewhere, Latin American borrowers may want to reassess their growth and debt management strategies. At the very least, the region may need to start looking east, rather than north, for financial assistance.

This article explores these issues in greater detail. It begins with a description of the financial market structure of the 1970s and the factors prompting United States and Japanese banks to jump into the international lending arena with such enthusiasm and vigor. As the discussion will show, the large current account surpluses of the Organization of Petroleum Exporting Countries (OPEC) had a much smaller impact on the growth of syndicated commercial bank loans to developing countries than is generally recognized. Instead, two less frequently discussed factors proved to be of much greater importance. The first was the regulatory environment confronting commercial banks in most creditor countries. The second was the decline in developed country economic growth rates. In tandem, these changes presented commercial banks with a strategic choice between domestic stagnation and international expansion based on rapidly rising volumes of syndicated loans to developing country borrowers. Not surprisingly, most commercial banks selected the latter option.

The second section explains how virtually every financial innovation and regulatory development during the 1980s reduced the region's access to international capital. In addition, it suggests that many of the financial market changes that are expected to occur during the remainder of this decade and the early part of the 1990s —especially the changing structure of domestic bank regulations in the United States and Japan and the emergence of a unified European market in 1992— will reduce the likelihood that commercial bank growth strategies and Latin America's external capital requirement will coincide anytime soon. The final section explores the strategic implications of these financial market innovations for Latin America's economic growth and debt management strategies.

I

International capital markets in the 1970s

In retrospect, it is clear that the 1970s were an anomaly. Almost without exception, every evolutionary trend and revolutionary development in the international capital markets seemed to channel additional capital towards Latin America. This section analyses some of the more important forces at work during the decade in order to show how they affected bank lending decisions and, more importantly, to explain why the region is unlikely to witness such a favourable constellation of forces

in the foreseeable future. The discussion begins by demonstrating that the link between the first oil shock and the growth of syndicated lending to Latin America is more complex than is generally realized. Among the additional variables that need to be considered are: a) the emergence of a two-tier international capital market; b) the impact of domestic bank regulations and international capital controls on the international lending volumes of United States banks; and c) the impact of rapidly increasing government budget deficits and dramatically slower domestic economic growth rates on the decision of Japanese banks to enter the international lending arena.

1. *OPEC and international capital flows*

The 1973 oil shock radically transformed the patterns of international capital flows. According to traditional historical accounts, OPEC current account surpluses flooded the banking system with liquidity and induced the banks to start making syndicated loans to developing country borrowers (Makin, 1984; Cohen, 1986). Unfortunately, this stylized version of events does not stand up well to either empirical or theoretical scrutiny.

From the banking industry's perspective, the main impact of the first oil shock was the dramatic redistribution of wealth from oil consumers to oil producers, not a sudden surge in banking system liquidity. This redistribution was reflected in the banking system's ledger, where the accounts of oil producers were credited and the accounts of oil consumers were debited. But since this bookkeeping transaction amounted to nothing more than a transfer of banking assets from one depositor to another, there is little theoretical justification for suggesting that OPEC surpluses actually increased the international banking system's overall liquidity.

The available empirical evidence supports this hypothesis. Following the 1974 failures of the Franklin National Bank in the United States and the Herstatt Bank in Europe, many commercial banks withdrew their funds from the Euromarkets, generating an overall decline in international liquidity. Consequently, United States banks financed their Euromarket lending operations, not by tapping the excess liquidity of OPEC depositors, but by transferring deposits from their domestic offices to their London branches (D'Arista, 1979). Thus, it was United States oil consumers, not Middle Eastern oil producers, who played a major role in maintaining the liquidity of the Euromarkets in the immediate aftermath of the first oil shock.

The pattern of interest rate spreads also suggests that many other factors besides OPEC surpluses affected the banking industry's willingness to accelerate their lending to Latin America. For example, if the banking industry were truly faced with excess liquidity, as the traditional history suggests, Latin American borrowers should have paid low spreads when OPEC surpluses were greatest and higher spreads as those surpluses diminished. In fact, just the opposite pattern prevailed. Latin American borrowers were charged high spreads in 1974 and 1975 when OPEC surpluses and, more importantly, OPEC deposits in the commercial banking system, were at their peak. Conversely, the spreads began to decline in 1977, at about the time that OPEC surpluses were declining and OPEC *borrowing* from the commercial banking system was beginning to accelerate. Clearly, additional factors governed the pace and volume of commercial bank flows to Latin America during this period.

2. *The two-tier international capital market*

One of the most important of these additional factors was the 600% growth of the Euromarkets during this decade (Cohen, 1986; Mendelsohn, 1980; Versluysen, 1981). In percentage terms, the growth of syndicated bank loans outstripped the growth of external bond offerings, especially in the post-1977 period (table 1). Nevertheless, every segment of the international financial market experienced rapid growth. More significantly, the financial markets were not the least bit reluctant to do business with developing country borrowers. Of the US$774 billion supplied by the international financial markets between 1973 and 1981, developing countries received US$236 billion, or approximately one third of the total (table 2).

Table 1

TOTAL FUNDS RAISED ON INTERNATIONAL FINANCIAL MARKETS

(Billions of US dollars)

	External bonds	Syndicated Eurocredits	Total
1973	8.6	20.9	29.5
1974	8.8	28.5	37.3
1975	19.7	20.6	40.3
1976	33.7	27.8	61.5
1977	34.9	33.8	68.7
1978	35.8	74.2	110.0
1979	37.3	79.1	116.4
1980	38.0	79.9	117.9
1981	47.8	145.3	193.1
Total	**264.6**	**510.1**	**774.7**

Source: Organization for Economic Co-operation and Development, 1982: "The medium-term Eurocredit market in 1978-1981", *Financial Market Trends*, No. 21, March, p. 5.

Table 2

BORROWING IN INTERNATIONAL CAPITAL MARKETS

(Billions of US dollars)

	External bonds	Syndicated Eurocredits	Total
	Developed:		
1973	6.5	13.9	20.4
1974	7.1	20.5	27.6
1975	16.3	9.5	25.8
1976	27.8	12.7	40.5
1977	26.9	16.1	43.0
1978	26.6	35.7	62.3
1979	30.4	29.0	59.4
1980	32.0	41.1	73.1
1981	39.2	90.1	129.3
Total	**212.8**	**268.6**	**481.4**
	Developing:		
1973	1.2	7.2	8.4
1974	.9	8.0	8.9
1975	.7	10.9	11.6
1976	2.0	14.2	16.2
1977	4.1	17.8	21.9
1978	5.3	34.2	39.5
1979	3.0	41.6	44.6
1980	1.8	34.5	36.3
1981	3.4	45.1	48.5
Total	**22.4**	**213.5**	**235.9**

Source: Organization for Economic Co-operation and Development, 1980: "Access by developing countries to international financial markets", *Financial Market Trends*, No. 13, February, p. 92, and 1982: "The market for external bond issues, 1973-1981", *Financial Market Trends*, No. 22, June, p. 20.

Despite the rapid growth in all segments of the financial markets and the apparent ease with which developing country borrowers obtained external financial resources, not all borrowers enjoyed equal access to every segment of the international financial markets. Nevertheless, during the 1970s, even the financial market's discriminatory practices worked to ensure that developing countries would have ample supplies of external financial resources. Simply stated, a two-tier international capital market emerged as early as the mid-1970s. In the upper tier were public and private borrowers from developed countries. Because of their high credit rating, these borrowers were able to obtain approximately 50% of their total external funds in the international bond market. The lower tier, by comparison, was inhabited by public and private sector borrowers from developing countries. Because these borrowers were perceived as less creditworthy, their only source of external financing was the commercial banking system, which generally supplied over 90% of their needs.

This two-tier market evolved out of a complex series of events. One crucial factor was the widespread stagflation in the Organization for Economic Co-operation and Development (OECD) area following the 1973 oil price shock. The resulting slowdown in OECD growth rates led to a steep decline in the private sector's demand for capital. Within the United States, for example, commercial and industrial bank loans declined by US$13 billion between 1974 and 1976 (D'Arista, 1976). This slowdown was not confined to the United States. As table 2 indicates, Eurocurrency bank borrowings by industrial country borrowers also declined sharply between 1974 and 1976.

At the same time, however, many of these industrial countries needed to finance sharply higher oil-induced current account deficits. Since they had relatively little external debt, high reserves and strong credit ratings, they had ready access to the international bond markets. Thus, at the same time that their bank borrowing declined by 40%, their borrowing in the international bond markets rose by US$20 billion, or 400% (United States Senate, 1977).

Because many of the top-rated public and private sector customers in developed countries

were deserting the banking system and raising funds directly in the securities markets, the banks needed to find new customers. In view of their sharply rising current account deficits, non-oil developing countries were more than willing to come to the banks' rescue. As a result, increased commercial bank loans to developing countries between 1974 and 1976 offset most of the decline in commercial bank lending to OECD borrowers.

This basic theme was repeated a number of times throughout the remainder of the decade: every time financial market developments militated against a growth of commercial bank loans to OECD borrowers, an equal and opposite reaction elsewhere in the financial system encouraged the banks to expand their lending operations to less developed countries (LDCs) instead. For example, the Federal Reserve Board's October 1979 decision to tighten the United States money supply is generally considered to be the first in a long series of events leading to the eventual outbreak of the debt crisis. A little noted side-effect, however, was that the Federal Reserve Board's action also encouraged United States banks to continue lending to Latin America.

As the OECD secretariat noted at the time, the Federal Reserve Board's October 1979 announcement "contained an 8% reserve requirement on increases in bank-managed liabilities, including Euro-dollar borrowings, loans made by foreign offices of Federal Reserve member banks to United States residents, and assets sold by member banks to related foreign offices; it did not affect, however, foreign lending by overseas branches of United States banks" (OECD, 1980, p. 2). In other words, in an attempt to control the domestic supply of credit, the Federal Reserve Board not only slowed the growth of the United States money supply but also tried to prevent commercial banks from counteracting its tight money policy by importing foreign funds for lending inside the United States. But since the Federal Reserve Board was only interested in restraining United States credit, it did not restrict bank lending to non-United States residents. Not surprisingly, United States banks responded by looking outside the United States for new business. Since OECD borrowers were still raising funds directly in the securities markets, banks had little choice but to increase their loans to LDC borrowers.

As this analysis suggests, banks started lending to Latin America, not because they were enthralled with the region's economic prospects *per se*, but because many of their better, more traditional customers were borrowing money elsewhere. A more detailed examination of the forces propelling United States and Japanese banks into the international lending arena will help to clarify this point.

3. *Origins of United States bank lending to LDCs*

The origin of United States bank lending to LDCs can be traced to 1969, when a combination of rising interest rates inside the United States and restrictions on the interest rate that United States commercial banks could pay depositors sparked a large-scale outflow of funds from the United States banking system (Wojnilower, 1980; Melton, 1977). However, United States banks quickly discovered a way to replace their lost deposits and circumvent the interest rate ceilings. They simply instructed their overseas branches to raise funds in the Euromarkets —where the interest rate they could pay depositors was not restricted by United States banking regulations— and lend the proceeds to the United States head office. Approximately US$13 billion entered the United States this way in 1969 (D'Arista, 1976).

However, when the 1970 recession reduced the United States domestic demand for loanable funds, United States banks repaid their overseas branches. This left the overseas offices with a surplus of funds and a shortage of borrowers. Compounding their problem was the fact that many OECD countries began prohibiting their residents from borrowing Eurodollars. These restrictions were designed to prevent residents from speculating against the dollar by borrowing dollars in the Euromarkets, converting them to local currency, and then waiting for the dollar to fall. By preventing these speculative flows, European central banks hoped to regain control over their domestic money supply.

However, these restrictions also meant that commercial banks were barred from making Euro-dollar loans to their best customers, United

States multinational corporations. Looking around, the banks settled on the next available group of borrowers —the developing countries. As a result, Eurocurrency bank lending to LDCs in the years preceding the first oil shock rose from a scant US$300 million in 1970 to US$7 billion in 1973. As a percent of total new credits extended by the Eurocurrency banks, loans to LDCs rose from 6.3% in 1970 to 20.7% in 1973 (D'Arista, 1979).

Syndicated loans to LDCs also became one of the most lucrative growth arenas open to United States commercial banks. According to data compiled by the United States Senate (1977), the domestic earnings of 13 large United States banks remained relatively stagnant between 1970 and 1976 (table 3). Those earnings were also quite sensitive to the ups and downs of the business cycle. Their international earnings, by comparison, rose much more rapidly and seemed quite impervious to the business cycle.

Table 3

DOMESTIC AND INTERNATIONAL EARNINGS OF UNITED STATES BANKS

(Billions of US dollars)

	International earnings	Domestic earnings
1970	177.3	884.4
1971	245.3	865.4
1972	337.0	858.9
1973	477.5	918.5
1974	616.3	1 014.5
1975	835.9	918.0
1976	886.2	905.2

Source: United States Senate, 1977: *International Debt, the Banks, and United States Foreign Policy*, a staff report prepared for the use of the Subcommittee on Foreign Economic Policy of the Committee on Foreign Relations, 95th Congress, first session, August.

4. *Origins of Japanese bank lending to the LDCs*

In Japan, the initial impetus for LDC lending had less to do with capital controls preventing commercial bank lending and much more to do with declining domestic growth rates and rising government budget deficits. As a result, "Banks [were] faced with a decline in loan demand from domestic corporations. Hence the search for good borrowers [brought] expansion into foreign markets" (Suzuki, 1986, p. 15). Consequently, the new motto in Japanese banking circles became "low growth and internationalization" (Guttman, 1987, p. 1258).

The post-war period preceding the first oil shock has been dubbed the "Japanese miracle". The Japanese economy expanded at an annual average rate of 10% between 1950 and 1973 and experienced its first recession only in 1974. However, in retrospect, the Japanese miracle actually ended in as early as 1971 or 1972, when the yen was revalued by 16% and many of Japan's capital intensive, heavy industrial sectors suddenly became uncompetitive (Lincoln, 1988, p. 216).

This slowdown in domestic growth rates had a serious destabilizing impact on the Japanese financial system. Since most Japanese corporations did not realize that the economy had entered a new era of permanently slower growth, they continued investing as if the old growth rates would continue indefinitely. With the onset of the 1974 recession, however, overcapacity became a serious problem. Real fixed investment declined at a 1% annual pace from 1974 to 1978, down from the 16% annual average rate of increase recorded between 1950 and 1973 (Lincoln, 1988, p. 43).

Because Japanese corporations had traditionally relied on commercial banks to supply the vast majority of their non-internally generated funds, the sharp drop in investment deprived commercial banks of their most lucrative and dynamic market. From 1965 to 1973, for example, private financial intermediaries, consisting primarily of commercial banks, supplied nearly three quarters of all the funds raised in the Japanese capital markets. By 1980, that share had declined to around 50% (Suzuki, 1986, p. 40). In other words, Japanese banks were supplying a declining share of funds to a stagnant market.

At about the same time, Japanese government budget deficits began increasing dramatically. During the "miracle" phase of Japanese post-war history, government surpluses averaged 1.9% of gross national product, thereby allowing Japan to finance its high growth rates without resorting to foreign borrowing. However, by 1972, leading members of the Japanese

ruling party started calling for a policy of deficit-financed spending for "social overhead capital and social security" (Lincoln, 1988, p. 22). Unfortunately, the government was as unprepared for the recession as the corporate sector. As the economic downturn gathered strength, the modest deficits forecast in the ruling party's economic platform started rising uncontrollably. Annual budget deficits rose to more than one trillion yen in the early 1970s and passed the 5 trillion yen mark in 1975. The deficits continued soaring, eventually reaching 14 trillion yen in 1981. In the wake of these deficits, the central government's outstanding debt rose from 8% of gross national product (GDP) in the late 1960s to 33% by late 1981 (Sakakibara, 1984), and its share of annual credit flows rose from 18% in the 1960s to 46.8% in 1980-1981 (Guttman, 1987, p. 1258).

Rather than offsetting the corporate sector's declining demand for loanable funds, the rapid increase in the government's budget deficits compounded the banking industry's problems. In order to minimize the government's debt servicing costs, the Ministry of Finance initially began issuing bonds at artificially low interest rates and requiring commercial banks to purchase a large portion of each issue. Since the Bank of Japan repurchased most of these bonds at par within one year as part of its efforts to increase the money supply in tandem with the economy's rapid growth, holding comparatively small quantities of government bonds was relatively painless and risk-free for the commercial banks. By the mid-1970s, however, this comfortable arrangement began to fall apart. As government deficits increased, the banks were forced to purchase rapidly increasing quantities of bonds. Meanwhile, as the slowdown in economic growth reduced the need for rapid money supply growth, the Bank of Japan halted its bond repurchase programme. Consequently, the share of low-interest government bonds in bank portfolios increased dramatically.

When the banks balked at purchasing more low-interest bonds, the Ministry of Finance started selling short-term bonds to the public at market rates of interest. Unfortunately for the banks, this generated a *de facto* short-term money market and prompted Japanese corporations to start managing their liquid assets more aggressively (Yoshitomi, 1985, p. 10). Rather than keeping their idle cash in low-yielding commercial bank accounts, they began investing in the newly emerging government securities market.

This combination of declining corporate investment and rising budget deficits squeezed bank profits from both the asset and liability side of the balance sheet. Simply put, the emergence of a short-term money market hastened the disappearance of the banks' low-cost deposit base while the decline in corporate investment kept loan demand stagnant. Not surprisingly, bank profitability plunged, with return on equity at Japan's city banks falling from 24% in 1974 to 15% in 1979 (Lincoln, 1988, p. 167). This prompted one Japanese banker to note:

> "Business has been sluggish in three ways. One has been the narrowing margin between the cost of our funds and the yields on our new loans... Second is that corporate treasurers... have been trying very hard to reduce their bank borrowings so that the banks have been unable to expand their lending. So the total volume of our lending was doomed to stay on a plateau while our interest rate margins were narrowing all the time. In addition to that, our business with the structurally depressed industries underwent a deterioration in quality... This brought an additional burden to the banks" (Bronte, 1979, p. 15).

Like their United States counterparts, Japanese commercial banks saw international lending as an antidote to declining domestic profit margins. During the late 1960s and early 1970s, the Ministry of Finance had allowed Japanese banks to make tentative forays into the international lending arena. However, Japanese banks were forced to retreat from the international markets when the Japanese economy ran current account deficits in the aftermath of the oil and food price shocks of 1972-1974. It is interesting to note in this respect that the withdrawal of Japanese banks from international lending during this period intensified the liquidity pressures in the Euromarkets, suggesting once again that the link between OPEC surpluses and the liquidity of the Euromarkets is more tenuous than is generally recognized.

However, these prohibitions on international lending were removed in 1977, shortly after the Japanese current account returned to surplus. As far as the Japanese banks were concerned, this new freedom could not have come at a better time. In the face of stagnant business demand and rising costs, international lending was seen as the easiest way to restore profitability. Thus, the removal of capital controls precipitated the "unrestricted entry of Japan's 13 city banks into the international lending arena... Suddenly, the competition became very rough as the city banks scrambled to establish a foothold in the newly opened market... The city banks moved immediately to take advantage of their new freedom in the international sector. Their cumulative overseas portfolios mushroomed by at the rate of about US$1 billion a month" (*The Economist*, 1984, p. 18).

For Latin American borrowers, these developments also represented the best possible news. The rapid influx of Japanese banks, along with the continuing entry of United States regional banks into the international lending arena, ensured a steady supply of fresh bank financing for each new round of syndicated lending. As a result, the liquidity of the Euromarkets increased steadily between 1977 and 1979, despite the fact that both OPEC current account surpluses and OPEC's deposits in the commercial banking system were not rising nearly as rapidly (Mattione, 1985, chapter 2; Sternlight, 1984). This additional liquidity was quickly translated into improved borrowing terms for developing country debtors. For example, spreads paid by LDC borrowers for syndicated loans declined sharply after 1977, even while their borrowing volumes increased and OPEC surpluses decreased. Between end-1977 and end-1979, the spread paid by developing countries fell by more than 70 basis points to approximately half the 1977 level. At the same time, the differential in the spread paid by top-rated OECD borrowers and typical developing country borrowers fell by two thirds, from 62 basis points at end-1977 to only 17 basis points at end-1979 (OECD, 1982a, p. 28).

II

Capital market developments in the 1980s

Compared to the previous decade when virtually every development in the international capital markets seemed to favour Latin America, most financial market developments during the 1980s appear to be depriving the region of external financial support. Consequently, while the region's debt service payments remain high, its ability to finance those payments with new inflows of external capital, as opposed to an outward transfer of real resources, remains seriously impaired.

One thing is certain, however. Latin America's recent inability to obtain financial assistance cannot be blamed on the stagnation of the international capital markets. The markets have been remarkably buoyant in recent years. Net bank and bond financing rose from US$130 billion to US$245 billion between 1983 and 1986 (table 4). That buoyancy continued in 1987, as the annual flow of net bank and bond financing rose to US$315 billion (Bank for International Settlements (BIS), 1988, p. 109). Nevertheless, these were precisely the years when Latin America's gross capital inflows plunged to practically zero and its net resource transfers reached all-time highs. Several evolutionary trends within the financial markets account for the discrepancy between the rapid growth of the international capital markets and the stagnation of capital flows to Latin America.

One of the most significant trends is the dramatic shift in the mode of international financial intermediation. During the 1970s, more than two thirds of all international capital flows moved through the commercial banking system, where the two-tier capital market provided Latin America with an ample supply of external credit. However, as the data in table 4

Table 4

ESTIMATED LENDING IN INTERNATIONAL MARKETS[a]

(Billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987
Net bank lending	160.0	165.0	95.0	85.0	90.0	105.0	165.0	255.0
Net bond financing	28.0	36.5	58.5	59.0	83.0	125.0	156.0	104.0
Bank plus bond	188.0	201.5	153.5	144.0	173.0	230.0	321.0	359.0
Double counting[b]	8.0	6.5	8.5	14.0	28.0	55.0	76.0	44.0
Net bank and bond	180.0	195.0	145.0	130.0	145.0	175.0	245.0	315.0

Source: Bank for International Settlements, 1985: *Fifty-fifth Annual Report*; 1987: *Fifty-seventh Annual Report*; 1988: *Fifty-eighth Annual Report.*

[a] Up to 1983, the reporting area consists of the G-10 countries, Luxembourg, Austria, Denmark, Ireland, and the offshore branches of United States banks in the Bahamas, Panama, the Cayman Islands, Hong Kong, and Singapore. As of 1984, the reporting area was expanded to include Finland, Norway, Spain, the branches of non-United States banks operating in the Bahamas, the Cayman Islands, Hong Kong and Singapore and all offshore units in Bahrain and the Netherlands Antilles.

[b] Double counting refers to bonds purchased by commercial banks for their own investment account.

reveal, annual flows of new bank lending declined by close to 50% during the first half of the 1980s, while net bond financing more than tripled. As a result, the most rapidly growing sector of the international capital markets was precisely the one that had traditionally been closed to developing countries.

A second evolutionary trend is the growing insularity of international capital flows. Although the capital markets were growing rapidly and becoming more international in scope, a diminishing share of these flows went to developing countries. In 1981, for example, 40% of net bank lending and 5% of international bond issues went to borrowers located outside the Bank for International Settlements (BIS) reporting area. During 1987, however, only slightly more than 1% of total bond finance and 10% of bank flows left the BIS area (BIS, 1988, p. 123).

In line with this development, Japanese residents became the largest consumers of commercial bank credit, despite the country's sizeable current account surplus and its status as the world's largest creditor nation. For example, Japanese residents borrowed US$72 billion from the international commercial banking system in 1987, up from approximately US$59 billion the year before. United States residents, by comparison, borrowed only US$45 billion in 1987 and less than US$20 billion the previous year (BIS, 1988; pp. 70, 72). Thus, if Latin America has been having problems attracting an adequate supply of international credit, it would appear that its chief competitor at the bank loan window has been Japan, not the United States.

Japan's status as the largest commercial bank borrower as well as the world's largest creditor is not a statistical anomaly. On the contrary, it is directly related to the way that Japanese investors have chosen to accumulate foreign assets. Simply stated, over the past three or four years, Japan's gross foreign investments have exceeded the country's current account surplus (table 5). The gap between the volume of Japan's long term investments and its cumulative current account surpluses has been financed primarily by commercial bank borrowing.

This process is highlighted in table 5. As can be seen, Japan's US$37 billion net investment surplus in 1983 consisted of a US$68 billion surplus in its long-term portfolio and a US$31 billion deficit in short-term assets, primarily loans from the international banking system. By 1986, that surplus in the long-term portion of Japan's portfolio had increased to US$283 billion. However, this US$215 billion increase was far greater than the country's cumulative current account surplus. Most of that difference was financed with short-term bank loans, thereby providing the commercial banking system with more than enough loan demand to offset any decline in lending volume to Latin America.

Table 5

JAPAN: NET INVESTMENT POSITION BY TYPE OF ASSETS[a]

(Millions of US dollars)

	1983	1984	1985	1986
Long term	68 100	115 962	178 969	283 800
Private sector	61 500	108 208	172 682	272 512
Direct investments	27 800	33 463	39 231	51 557
Trade credits	17 900	22 800	23 472	31 959
Loans	28 000	39 335	45 659	68 012
Securities	(13 800)	10 497	60 901	114 322
Other	1 500	2 113	3 419	6 662
Government	6 700	7 754	6 287	11 288
Short term	(30 800)	(41 616)	(49 148)	(103 449)
Private sector	(49 600)	(61 139)	(68 232)	(133 971)
Monetary movements	(35 200)	(52 536)	(61 265)	(127 450)
Other	(14 400)	(8 603)	(6 967)	(6 521)
Government sector	18 800	19 523	19 084	30 522
Monetary movements	21 800	23 671	23 093	36 191
Other	(3 100)	(4 148)	(4 009)	(5 669)
Memo item:				
Current account	20 800	35 000	49 200	85 800

Source: For 1983 data, Bank of Tokyo, 1985: "Japan's external assets and liabilities", *Tokyo Financial Review*, March. For remaining years, Japan Economic Institute, 1986: "Japan's role in world financial Markets", *Japan Economic Institute Report*, No. 42A, November 14, and 1987: "Japan still the world's top net creditor nation", *Japan Economic Institute Report*, No. 21B, June 5.

[a] Figures in parentheses denote deficits.

A third, and more recent, evolutionary development is the almost total collapse of the floating rate note (FRN) segment of the international capital markets and the simultaneous revival of commercial bank lending.[1] From a peak of US$55.9 billion in 1985 and a respectable US$47.8 billion in 1986, the volume of newly issued floating rate notes fell to US$12 billion in 1987 (BIS: 1988, p. 126). Meanwhile, the pace of international bank lending increased from a rather lackluster US$55 billion in the first half of 1986 to US$110 billion in the second half of 1986, US$135 billion during the first half of 1987 and US$120 billion in the second half of that year.

These two trends are not unrelated. Syndicated lending revived precisely because floating rate notes and commercial bank loans are close substitutes. For LDC borrowers, however, these trends are simply one more illustration of how virtually every financial development in the 1980s worked to inhibit the flow of funds to developing countries. Simply stated, even though Latin America's financial problems did not cause the collapse of the floating rate note market and despite the fact that the region never used these instruments to raise much capital, Latin America can expect to notice several adverse effects from its collapse.

During the mid-1980s, United States commercial banks raised large amounts of capital by issuing perpetual floating rate notes —i.e., floating interest rate securities with no fixed maturity date. As the OECD noted recently:

For banks, the availability of a broad market in FRNs —where the banks have raised funds exceeding US$100 billion during the 1985-1986 period— has meant the possibility of securing a better matching of assets and liabilities both in terms of interest rates and maturities. [In addition], the introduction of long-term floating-rate instruments which can be assimilated to capital for supervisory purposes —e.g. perpetual FRNs in the form of subordinated debt— has provided banks with a badly-needed opportunity

[1] For a description of floating rate notes, see BIS, 1986, Levich, 1987.

to raise capital-like funds and to strengthen their balances sheet (OECD, 1987a, p. 52).

However, the demise of floating rate notes will make it more costly for banks to raise additional capital. This, in turn, should make banks even more reluctant to extend new loans, write-off a portion of their existing claims or take other actions that might reduce the region's net resource transfer. In addition, since commercial bank loans and FRNs are close substitutes, the collapse of the floating rate note market has provided commercial banks with a new and rapidly increasing pool of top-rated borrowers. And since the banks began lending to Latin America precisely because many of their best customers were raising funds directly in the securities markets, the return of these valued customers will reduce the need for many banks to maintain close business relationships with Latin America. Again, as the OECD noted, "Activity on the syndicated credit market has strengthened significantly since the middle of last year....[While sovereign borrowing remains modest by past standards, the market has accommodated with remarkable speed and efficiency a growing volume of corporate demand" (OECD, 1987b, p. 50).

Obviously, these developments do not bode well for Latin America. When securitized lending was in fashion earlier in the decade, Latin American borrowers were unable to raise funds in this segment of the market. But now that the securities sector is in the midst of a contraction and many top-rated borrowers are turning to the syndicated loan market, Latin America will once again find itself at the end of the credit queue. Moreover, it stands to reason that if the region had difficulty obtaining loans when the international markets were buoyant and robust, it is unlikely to fare better now that one of the banks' major sources of capital has disappeared.

The impact of these adverse developments within the international financial markets themselves will be reinforced by the new regulatory and business climate in individual banking centres that will confront United States, European and Japanese banks during the remainder of the 1980s and the early part of the 1990s. Unlike the previous decade, the net effect of these changes will be to raise the opportunity cost of doing business in Latin America, thus making the commercial banks even more interested in focusing their capital and managerial resources closer to home. These developments have already induced United States banks to retreat from the international lending arena. Additional changes scheduled to take effect during the next few years can be expected to reinforce these trends and induce similar shifts in the international lending policies of Japanese and European banks.

1. *The retreat of United States commercial banks in the 1980s*

In view of Latin America's recent problems obtaining new commercial bank loans, it is tempting to argue that the banks' refusal to lend is motivated primarily by the region's existing debt overhang. In fact, United States banks have shown a greater willingness to lend to Latin American borrowers than to borrowers in almost any other region. According to official United States banking data, the growth of United States bank loans to Latin America and the Caribbean —excluding Ecuador and Venezuela, which are listed in the OPEC category— levelled off in 1983 and 1984, rising during those two years at an annual rate of only US$1.5 billion (table 6). This was down significantly from the US$8.6 billion annual average increase registered between end-1977 and end-1982, but no other region, developed or developing, increased its loans from United States banks at a faster rate (Bennett and Zimmerman, 1988). Moreover, between end-1982 and end-1987, United States bank exposure to Latin America declined by just under US$6 billion, compared to a combined US$21 billion decline in exposure to the developed countries, including both members and non-members of the Group of Ten.

As these statistics indicate, Latin America's efforts to obtain new loans were hampered not only by the region's structural overindebtedness but by what appears to be a general retreat of United States banks from the international lending arena. Part of this retreat undoubtedly reflects the decision of smaller banks to focus on lending opportunities closer to home. However, the retreat was not confined solely to this segment of the United States banking industry. Many of the larger regional and multinational banks that could be expected to have a longer-

term commitment to the international financial markets also stopped increasing their international exposure and slowed the growth of their balance sheets.

One of the most impressive signs of their retreat is the relative decline of United States money centre and large regional banks. In 1980, for example, Dai-Ichi Kangyo Bank, at number 10, was the only Japanese bank to rank among the top 10 in the *Euromoney* list of banks ranked by assets. By 1987, however, Japanese banks occupied all five of the top five slots and eight of the top 10 positions. Citicorp, at number 10, was the only United States bank to remain in the top tier. Japanese banks filled five of the next 10 slots; United States banks filled none. Indeed, only four United States banks —Citicorp, Chase Manhattan, Bank of America and Chemical— even ranked in the top 50, compared to 20 Japanese banks.

Besides their commanding presence in the *Euromoney* tables, 12 Japanese banks are among the 25 largest banks operating in the United Kingdom, where they account for 31% of all the international liabilities booked in London, up from 13% as recently as 1981. Japanese banks also account for 8.4% of all commercial bank loans outstanding in the United States. They underwrote US$18 billion, or 50%, of all United States municipal bonds issued in 1986 and control five of the 11 largest banks comprising 13% of the total banking market in California (*Far Eastern Economic Review*, 1987, p. 86; Stokes, 1988, p. 247).

More telling than these relative rankings is the absolute size of the consolidated assets controlled by banks chartered in different countries. In 1980, for example, only two United States banks —Citicorp and Bank of America— and two French banks —Crédit Agricole and Banque National De Paris— had assets of more than US$100 billion. The average assets of the top 10 United States banks and the top 10 Japanese banks were approximately equal, at US$54.9 billion and US$58.6 billion respectively. In 1987, Citicorp was the only United States bank with assets of more than US$100 billion. Meanwhile, 16 Japanese, three German, five French, two British and two Swiss banks occupied this once-elite group.

2. *United States bank regulations and United States bank lending in the 1980s*

The relative stagnation of United States banks and the phenomenal growth of Japanese banks did not occur in a vacuum. For Japanese banks, the yen's rise since February 1985 is partially responsible for their rapid growth during the past two years. Similarly, the rapid growth of Japan's exports gave Japanese banks a built-in advantage in the realm of trade financing. Nevertheless, these factors explain only part of the story. Japanese banks also increased their relative standing in the *Euromoney* 500 list between 1982 and 1984 when the yen was declin-

Table 6

UNITED STATES BANK EXPOSURE BY REGION[a]

(Billions of dollars)

	G-10 and Switzerland	Non-G-10 developed	Eastern Europe	OPEC	Latin America	Asia	Total
1981	150.1	32.1	7.3	22.4	62.8	27.5	320.4
1982	161.9	38.0	5.9	24.3	70.6	32.7	351.6
1983	164.3	41.3	5.2	25.0	71.1	33.2	359.3
1984	147.0	39.0	4.6	22.9	73.7	29.6	332.2
1985	144.0	34.5	4.2	20.0	69.7	26.5	311.8
1986	144.2	30.1	3.6	17.4	68.2	22.2	296.8
1987	152.3	26.6	3.2	14.6	64.8	19.4	290.8

Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*, various years.

[a] Exposure data is adjusted for guarantees and indirect borrowing. Totals do not add due to the exclusion of data for Africa, offshore banking centres, and international and regional organizations.

ing. And changing currency value and rising export volumes cannot explain the entry of so many comparatively unknown Japanese banks into top positions in the list of the world's largest banks. Conversely, the debt problems of Latin America and Eastern Europe cannot account for the relative stagnation of United States banks. Japanese and European banks had equal, if not greater, exposures to these two financially-troubled regions. And yet international debt problems only seem to have affected the growth of United States banks.

What seems to be inhibiting United States banks is an adverse profit and regulatory environment. As a result, United States banks are discovering that it is in their best interest to slow their total asset growth in general and their international lending profile in particular. Obviously, this makes it more difficult for Latin American borrowers to obtain external financial support. In many respects, this is one of the most striking differences between the global financial environment of the 1970s an that of the 1980s.

i) *Rising capital costs.* During the 1970s, rapid asset growth was the key to increased commercial bank profitability, especially during periods when interest rate spreads were declining. By sponsoring new loan syndications and making the syndication fees immediately into profits, banks could maintain, and even increase, their gross profit margins. However, this strategy could succeed only if banks were generating increasing amounts of syndication fees which, in turn, required generating increasing amounts of syndicated loans. During the 1970s, in other words, the profit and growth strategies of the banks were congruent with the financial needs of developing countries.

Helping to sustain this symbiotic relationship were the generally lax capital requirements placed on the largest United States banks. Money centre banks and regional banks with more than US$1 billion of assets entered the 1970s with capital asset ratios of slightly less than 6%. By 1981, that ratio had fallen to 3.9% for money centre banks and 4.6% for the large regional banks (New York Federal Reserve Bank Staff, 1987, p. 15). These declining ratios allowed the money centre and regional banks to increase their return on equity from approximately 11% during the early 1970s to more than 13% in 1981, despite increased competition, declining interest rate spreads and generally lower syndication fees.

United States banks came under increased pressure to raise their capital asset ratios after 1983 when Congress authorized the Federal Reserve Board to establish minimum capital standards for the largest bank holding companies. In the wake of these stricter standards, United States banks raised more than US$58 billion of additional capital since end-1982 (table 7). However, since the banks' return on assets has not increased appreciably, bank profitability, as measured by return on equity, has been stagnant at best, and declining in many cases (Salomon Brothers, 1987, pp. 56-57).

Adding to the banks' woes is the fact that their cost of capital is much higher than that of their domestic investment bank and Japanese commercial bank rivals (New York Federal Reserve Bank Staff, 1987; Mead and Gluck, 1987, p. 270). This puts United States banks at a severe competitive disadvantage. On the one hand, they need higher loan spreads and return on assets merely to break even. As the New York

Table 7

UNITED STATES BANK CAPITAL[a]

(Billions of dollars)

	1982	1983	1984	1985	1986	1987
All reporting banks	70.6	79.3	92.2	105.4	116.1	129.2
Top nine	29.0	31.5	36.7	42.3	46.7	51.5
Next fifteen[a]	13.5	14.9	18.1	20.6	22.0	23.9
All other	28.1	33.0	37.4	42.5	47.4	53.8

Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*, various years.
[a] Bank mergers during the second half of 1987 reduced the "next fifteen" category to 13 banks by end-1987.

Federal Reserve Bank explained in a recent study of bank profitability, "The hurdle rate of return for capital to be invested in new projects at large banks (especially at multinational) has had to be *quite* high on average in this decade, well above the rate of return on existing capital as measured by bank returns on equity and far above the rate of return demanded by the market for corporate business in general" (emphasis in original) (New York Federal Reserve Bank Staff, 1987; p. 31). And yet at the same time that they must generate higher rates of return, United States banks are finding that the more highly leveraged Japanese banks are offering to make loans at much lower spreads.

ii) *The growth of off-balance-sheet assets.* In an effort to increase their gross profits, and thus their return on equity, United States banks have been searching for less capital-intensive operating procedures. To an increasing extent, this means that syndicated loans have been falling out of favour while so-called fee-generating, off-balance-sheet financial services such as letters of credit, currency swaps and interest rate swaps are gaining prominence. According to the United States Federal Deposit Insurance Corporation, for example, off-balance-sheet items have been one of the most rapidly growing lines of business for United States commercial banks (Chessen, 1987, p. 4). They totalled less than US$250 billion in 1980, or 250% of the banking system's total capital. By 1987, the value of all off-balance-sheet items had risen to approximately US$2.3 trillion, or more than 1 300% of bank capital. In line with these estimates, the New York Federal Reserve Bank notes, "money center holding companies seem to be earning an increasing share of their profits from non-lending-related activities. The primary difference between one set of estimates and another is the pace of this change. For example, before loan loss provisions, favourable assumptions suggest that lending-related activities' share of pre-tax profits fell from about 85% of the total in 1980 to about 65% in 1984 and 1985. Less favourable assumptions suggest that the loan-related share of profits fell from about 65% in 1980 to about 35% in 1984 and 1985" (Proctor, 1987, p. 242).

From the banks' perspective, the advantage of this shift away from syndicated loans is that they are not required to hold capital against off-balance-sheet items. On the other hand, because new loans require additional capital, their effect on return on equity is more ambiguous. As a result, the link between bank profitability and Latin America's financial requirements has become more tenuous. But of course this is just one more illustration of how the dominant commercial banking trends in the 1980s worked against the region and would have done so even if there were no debt crisis.

iii) *New bank regulations.* These competitive pressures and trends in the banks' preferred mode of doing business have spawned a number of proposed revisions, as well as actual changes, in United States bank regulations. In all likelihood, these will make banks even more reluctant to provide additional financial support to developing countries. For example, one proposal would expand the opportunities for banks to earn fee income. Under current rules, commercial banks are legally forbidden to engage in many of the most lucrative fee-generating financial activities such as underwriting corporate stocks, bonds and commercial paper. The primary legal barriers are the depression-era Glass-Steagall Act separating investment banking from commercial banking and the Bank Holding Act restricting the sorts of financial services corporations that bank holding companies can own (Jackson and Cohen, 1986; Jackson, 1987; D'Arista, 1986).

Several proposals, including one sponsored by New York Federal Reserve Bank President Gerald Corrigan (1987), would allow commercial banks to engage in a variety of previously forbidden securities-related activities. However, in order to exploit these new opportunities, banks will have to raise large amounts of capital. Given the demise of the floating rate note market and the depressed price of most bank stocks, raising the additional capital needed to enter the investment banking field could prove to be both expensive and difficult. Therefore, banks will probably be extremely reluctant to divert whatever scarce capital they do have away from investment banking activities simply so that more will be available to support syndicated lending to highly indebted countries.

Ironically, the proliferation of United States bank failures could also discourage banks from providing additional financial assistance to Latin

America. Two banking rules and practices are crucial to understanding how this process may operate. First, under current United States rules and regulations, banks are restricted from conducting business in more than one state. Second, rather than closing an insolvent bank and paying off the insured depositors, the Federal Deposit Insurance Corporation (FDIC) —the United States government agency that insures depositors against losses resulting from bank failures— usually tries to sell bankrupt commercial banks to healthier financial institutions. As a condition of the sale, the FDIC often guarantees that it will absorb all current and at least some future losses in the failed bank's loan portfolio. However, in an effort to encourage additional banks to bid for the failed bank's assets, thereby reducing the government's cost of liquidating the insolvent bank, commercial banks located in one state are permitted to acquire insolvent banks in a different state. This waiver of the prohibition against interstate banking offers banks a golden opportunity to establish a multistate network of branches and loan offices.

Many United States banks are now putting their capital as well as their managerial time and expertise into acquiring insolvent banks and competing aggressively for the profitable lending business that the failed banks were too weak to pursue. As a result, the expansion plans of many of the healthiest regional banks no longer require the rapid growth of lending volumes to Latin America. For the moment at least, all the expansion they can afford is available in domestic markets. Moreover, since the United States government absorbs all the losses in the insolvent bank's portfolio, acquiring an insolvent bank would appear to be a relatively risk-free route to expansion. Certainly, it is less risky than making new loans to Latin America. Not surprisingly, a number of regional and money centre banks have concluded that purchasing insolvent banks is a more profitable and safer way to deploy their available capital. Since there is no shortage of failing banks, this process can be expected to continue for some time —as will the bank's reluctance to return to the developing country syndicated loan market.

3. *Regulatory pressures on European and Japanese banks*

Until recently, the international expansion plans of Japanese and European banks were not affected by the same factors that hobbled their United States counterparts. However, within the next few years, this situation will change dramatically, closing off still more avenues of financial support for Latin America. Two pending regulatory changes merit special attention.

i) *Capital adequacy standards.* The first is the new minimum capital standards schedule to take effect in 1992 (Bardos, 1987; Board of Governors, 1988; Osborn and Evans, 1988). Under the terms of this 11-nation proposal, commercial banks will have to maintain capital equal to at least 8% of their risk-adjusted assets. However, this simple and seemingly modest-sounding proposal contains several dramatic changes in current capital adequacy standards. Among other things, it mandates that at least half of each bank's total capital —its so-called tier one capital— must consist of shareholders' equity. In addition, the proposal limits the amount of loan loss reserves that can be included in the remaining, or tier two, portion of total capital. The proposal also requires each bank to maintain capital against all of its off-balance-sheet assets.

Finally, the capital guidelines place all assets into various risk categories. Assets that have a lower risk weighting require less capital than assets with a higher risk weighting. While the precise details of this risk-weigthing procedure are not of interest here, it is sufficient to note that loans to developing countries are in the highest risk-weigthing category, along with loans to most private sector borrowers within the BIS area. Thus, when all is said and done, the new capital guidelines will require the banks to raise one dollar of capital whenever they increase their LDC exposure by US$12. At least half of this additional capital must be in the form of shareholders' equity.

ii) *Europe 1992.* Under the terms of another proposal recently adopted by the European Economic Community (EEC), all barriers to international commerce within the EEC will be

eliminated in 1992 (Bellanger, 1988; Commission of the European Communities, 1988; Hale, 1988). Once these barriers have been dismantled, any corporation doing business in one country will be entitled to expand into any other country within the EEC. This unlimited freedom of expansion pertains to bank as well as non-bank corporations. Thus, according to the European Parliament's "second Banking Directive", any bank licensed to do business in one European country can engage in any acceptable banking activity anywhere within the EEC. The definition of "acceptable" includes the full range of investment and commercial banking services. Moreover, the provisions of the Second Banking Directive will generally apply to United States and Japanese banks that already have at least one office within the EEC.

iii) *Consequences.* At this early date, it is difficult to predict with any degree of certainty precisely how the new capital adequacy guidelines and European deregulation moves will influence commercial bank attitudes towards making new loans to Latin America. However, a number of tentative conclusions are possible, all of which suggest additional reasons why commercial banks will become even less interested than they are today in providing balance-of-payment support for developing countries.

According to preliminary analysis, the new capital guidelines can be expected to retard the planned expansion of most commercial banks, at least initially. The United States investment banking firm of Goldman Sachs estimates that 14 large United States banks, including Manufacturers Hanover, Bankers Trust, Irving Bank, Continental Illinois, Security Pacific and First Republic, will have to raise approximately US$14 billion of additional capital by the end of 1992 if they are to comply with the new capital guidelines. This estimate assumes that the affected banks do not expand their balance sheets between now and the end of 1992. In addition, United States banks will need at least US$20 billion of additional capital to replace the after-tax value of the shareholders' equity that would be consumed by writing down their LDC loans to 50% of their current face value. Combining just these two items, it would appear that United States banks will need between US$14 billion and US$34 billion of additional capital to finance their current loan portfolios (Hale, 1988, p. 108; General Accounting Office, 1988).

Japanese banks could face similar pressures, although the precise impact of the capital guidelines on their expansion plans is still subject to considerable speculation and uncertainty. However, one widely quoted and respected study by the Nomura Research Institute estimates that Japanese banks will have to slow their asset growth from 7 to 8% per year, down from the 12 to 13% annual growth registered during the past 10 years, if they hope to limit their new capital raising requirements to 7 trillion yen to 8 trillion yen (approximately US$50 billion to US$60 billion assuming and exchange rate of 130 yen to the dollar) (Wagstyl, 1988).

In view of these additional capital requirements, it is difficult to envision either United States banks or Japanese banks raising still more capital so they can expand their exposure to developing countries. Preliminary indications are that this will certainly be true for Japanese banks. For example, Japanese banks are expected to become more active in their domestic consumer lending market where there is less international competition, and profits, at least for the moment, are higher. This would also give them an integral role in financing Japan's transition from an export-led economy to one that places greater emphasis on internal demand. Loans to mid-size domestic corporations are also expected to increase (Osborne and Evans, 1988).

Finally, when Japanese banks do venture overseas, it is expected that they will focus their efforts on the United States market, where the continued popularity of leveraged buyouts, junk bond financing, and other merger-related transactions offers much higher yields. In this respect, it is important to point out that under the capital guidelines, the capital needed to purchase a junk bond issued by a United States corporation will be equal to the capital needed to make a syndicated loan to Latin America. But since loans to Latin America currently carry a spread of 13/16 over the London interbank offered rate (LIBOR) while junk bonds are yielding at least 400 to 500 basis points above LIBOR, it is not difficult to see why a profit maximizing bank will always prefer the latter.

Just as the new capital requirements are expected to make commercial banks less eager to

expand their Latin American exposure, Europe's forthcoming financial deregulation could also increase the banks' opportunity cost of doing business in developing countries. For example, according to the current conventional wisdom, large European banks will have to start merging with each other if they want to survive and prosper in the post-1992 era. "The question is not whether to buy, but to buy. The number of deals will be staggering", explained one close observer of the European banking scene (Phillips, 1988, p. 54). Acquiring other banks, however, will require vast amounts of capital. As one European banker said recently, "Capital is the number one issue of the moment. It's vital first for banks to finance natural business growth at home —which they are not doing at present— and secondly to finance acquisitions" (Shale, 1988, p. 72). In addition, the 1992 deregulation is expected to spark a large number of mergers among European non-bank corporations (Fairlamb, 1988). The commercial banks hope to provide financing for many of these mergers as well. As a result, European banks, like their United States counterparts, are expected to place much greater emphasis on domestic business opportunities as well as on defending their established niches from the competitive encroachments of rival banks. In this environment, it is highly unlikely that any bank will conclude that adding more Latin American loans to its portfolio will strengthen its competitive position within Europe. Moreover, when European banks do look overseas, they will be more likely to focus their attention on the United States which absorbs 10% of Europe's exports, than on Latin America, which purchases less than 3% of the EEC's exports. In other words, Latin America can expect to become an increasingly irrelevant factor in Europe's medium-term trade and financial plans.

III
Conclusions

Since the onset of the debt crisis more than six years ago, officials in both creditor and debtor nations have operated on the assumption that commercial banks would start making new loans to developing country borrowers once the debtors completed their macroeconomic adjustments and restored their creditworthiness. As this paper has demonstrated, however, life may not be this simple. A comparison of the factors that induced banks to begin lending to developing countries in the 1970s with the conditions prevailing during the 1980s and likely to prevail in the 1990s suggests that the commercial banks' long-term business interests may no longer coincide with Latin America's debt service and investment requirements.

How should Latin American political and economic officials respond to the strategic challenge posed by these new facts of life? Several answers immediately come to mind. First, and perhaps foremost, debtor nations will have to rely to a much greater extent than before on internally generated savings. So far, the response to the disappearance of external savings has been a sharp decline in investment. In order to protect Latin America's long-term growth potential, this process will have to be reversed.

Secondly the World Bank and Inter-American Development Bank should also consider how they could respond to this challenge. Should they attempt to fill the financial gap left by the retreat of the commercial banks by increasing their own disbursements? If the answer is yes, how will this decision affect their own credit rating, and hence their own long-term ability to assist the region? Alternatively, should they reduce their own lending on the grounds that without sufficient burden sharing by the commercial banks, structural adjustment will be much more difficult, and therefore much less likely to succeed? There are no easy or obvious answers.

Finally, if commercial banks cannot be induced to put sufficient new funds into debtor

nations, then debtor nations may want to consider looking for ways to harness the strategic interest of the commercial banks to the goal of debt relief. This may not be as difficult as it might first appear. In terms of United States banks, for example, generally accepted accounting practices dictate that banks must establish loan loss reserves only if they believe that they will be unable to collect the outstanding principal. Reserves are generally not required if a bank merely reduces its interest rate on an existing loan.

At a time when United States commercial banks are under increasing pressure to raise additional capital and at a time when their loan loss reserves will no longer be counted as tier one capital, interest rate concessions, rather than making new loans or forgiving part of the outstanding principal, may prove to be in the best interests of both creditors and debtors. From the banks' perspective, new loans require additional capital and write-downs consume existing capital. But since it could be argued that interest rate concessions increase the probability that banks will eventually be able recover their outstanding claims, United States bank regulations would probably allow banks to convert their existing loan loss reserves back into tier one capital. At least one member of the United States Congress has already made this argument (Pease, 1988). Thus, in the wake of interest rate concessions, debtors would reduce their net resource transfers while banks strengthen their capital base and obtain the resources which they need to expand into what they see as more strategically important lines of business.

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